

BEFORE THE
PUBLIC SERVICE COMMISSION
OF DELAWARE
CASE NO. _____

CHESAPEAKE UTILITIES CORPORATION

Direct Testimony

of

Paul R. Moul, Managing Consultant
P. Moul & Associates

Concerning

Concerning Cost of Capital

DIRECT TESTIMONY OF PAUL R. MOUL

1 **Q. Does your cost of equity analysis and recommendation take into account the**
2 **Revenue Normalization Mechanism (“RNM”) that the Company is proposing**
3 **in this case?**

4 A. Yes. The Company proposes to include in its tariff the RNM that is intended to
5 “decouple” the recovery of the revenues for a given customer class from usage of
6 the customers in that class. My cost of equity analysis that provides an 11.50% rate
7 of return on common equity takes into account the Company’s proposal.

8 **Q. Do the LDCs included in your Gas Group already have tariff mechanisms**
9 **similar to the RNM?**

10 A. Yes, and therefore my analysis already reflects the impacts of the RNM on investor
11 expectations through the use of market-determined models. Six of the companies in
12 my Gas Group already have some form of revenue adjustment mechanism and one
13 remaining company has a weather mitigation rate design intended to deal with the
14 effect of weather volatility during the months of December through May. As such,
15 the market prices of these companies’ common equity reflect the expectations of
16 investors related to a regulatory mechanism that adjust revenues.

17 **Q. How do investors assess the risk to an LDC for variations in customer usage**
18 **under conditions of normal weather, which the RNM is designed to**
19 **accommodate, among other factors?**

20 A. Investors in a gas utility can only formulate reasonable expectations based upon
21 normal weather, although achieved results may vary significantly from those
22 expectations from year to year due to variations in weather. That is to say, a
23 rational investor in a gas utility can only anticipate, and base his or her analyses on

DIRECT TESTIMONY OF PAUL R. MOUL

1 normal temperature conditions. The financial theory upon which the cost of equity
2 is based recognizes that investors value their investments on a long-term basis
3 covering a number of years, not just one year. For example, the DCF formula
4 explicitly assumes a growth rate “approaching infinity.” Additionally, as I will
5 discuss later, analysts’ forecasts of utilities’ earnings and dividend growth, which
6 investors take into account in making investment decisions, typically are provided
7 on a five-year basis. Weather, by definition, is normal over the long-term or multi-
8 year period, although it may vary significantly from year to year. Moreover, one of
9 the standard models of the cost of equity (i.e., CAPM) suggests that there is no
10 measurable effect on the cost of equity because weather represents a company-
11 specific risk, which does not receive compensation in the CAPM. Therefore, the
12 theories and models underlying my cost of capital analysis obviate the need for any
13 adjustments based upon short-term phenomena such as weather variations which
14 have no long-term effect. Accordingly, over the long term, the investor required
15 cost of capital or discount rate assumed for an investment in a gas utility would be
16 the same either with or without a RNM.

17 That is not to say there are no benefits to the proposed RNM. Variations in
18 weather can significantly affect customers' bills and the Company's cash flow.
19 Fluctuations in bad debt expense from year to year, which may also be driven in
20 part by variations in weather, also affect the Company’s cash flow. Therefore, the
21 Company can be expected to realize a short-term benefit of improved or at least
22 more predictable liquidity as a result of implementation of the RNM. Indeed, the
23 RNM will remove some of the Company’s cash flow variability.

DIRECT TESTIMONY OF PAUL R. MOUL

1 **Q. How should the Commission respond to the issues facing the natural gas**
2 **utilities and in particular Chesapeake?**

3 A. The Commission should recognize and take into account the heightened
4 competitive environment in the natural gas business in determining the cost of
5 capital for the Company and provide a reasonable opportunity for the Company to
6 actually achieve its cost of capital.

7